

# **REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND COUNCIL ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF MHLONTLO LOCAL MUNICIPALITY FOR THE YEAR ENDED 30 JUNE 2009**

## **Introduction**

1. I was engaged to audit the accompanying financial statements of the Mhlontlo Local Municipality which comprise the balance sheet as at 30 June 2009, income statement, statement of changes in funds and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, as set out on pages xxx to xxx.

## **The accounting officer's responsibility for the financial statements**

2. The accounting officer is responsible for the preparation of these financial statements in accordance with the entity specific basis of accounting, as set out in accounting policy note 1 and in the manner required by the Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and for such internal control as the accounting officer determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

## **The Auditor-General's responsibility**

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008*. Because of the matters described in the Basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

## **Basis for disclaimer of opinion**

### **Cash and Cash equivalents**

4. The bank and cash balance of R2.2 million disclosed in the balance sheet and note 7 of the financial statements was not adequately reconciled to the bank statement which reflected an overdraft of R1.9 million. The reconciling amount of R4.1 million was not detailed and supported by documentation.
5. Journals amounting to R34.4 million were debited into cash and cash equivalents and R65.2 million credited out of cash and cash equivalents with no supporting documentation.
6. As a result I was unable to obtain sufficient appropriate evidence to confirm the completeness, accuracy, existence and valuation of the bank and cash balance.

## **Provisions**

7. Sufficient appropriate evidence relating to the existence, completeness, accuracy and valuation of the provision for leave pay of R1.6 million included in the provisions balance of R4.9 million and detailed in note 9 to the financial statements could not be obtained. This was as a result of leave taken not captured on the system and recorded leave not being supported by documentation.
8. Also included in the provisions balance is an amount of R401 006 relating to a bonus provision which could not be supported with appropriate documentation.
9. Furthermore, included in this balance is also an amount of R2.9 million relating to the provision for bad debts, which has been incorrectly disclosed as a liability in the financial statements and also included as a deduction from debtors. This figure is thus accounted for, twice in the balance sheet and incorrectly classified as a liability.

## **Expenditure**

10. Due to a lack of supporting documentation sufficient appropriate evidence relating to the occurrence of expenditure of R24.2 million out of a total expenditure of R69.6 million could not be obtained. The state of the municipality's records prevented the application of alternative procedures on this expenditure.
11. Expenditure totaling R 852 455 has not been recorded in the general ledger. The financial statements are therefore understated by this amount.
12. Accruals to the value of R2 million have been identified during our audit of creditors and have not been accrued for in the current financial year. As a result expenditure and accounts payables are therefore understated by this amount.
13. Journals amounting to R7.2 million were credited out of expenditure without supporting documentation.
14. Audit fees amounting to R1.2 million are not disclosed in the annual financial statements as required by section 125 of the MFMA.

## **Employee Costs**

15. Payroll liabilities of R1.2 million have not been accrued. As a result creditors and employee costs are understated by this amount.
16. Medical and pension contributions amounting to R2.6 million and R1.5 million respectively were not disclosed in the annual financial statements as required by section 125 of the MFMA.

## **Investments**

17. Journals amounting to R5.6 million were debited from investments and R10.6 million credited to investments without supporting documentation. As a result I was unable to obtain sufficient appropriate evidence to confirm the accuracy, existence and valuation of the investment balance.

### **Irregular expenditure**

18. Irregular expenditure of R12.1 million was omitted from the annual financial statements. This irregular expenditure was incurred in contravention of the municipality's supply chain management policy.

### **Unauthorised expenditure**

19. Conditional grants intended for housing projects were used to finance operational activities. As a result unauthorised expenditure of R1.3 million was incurred. This unauthorised amount is not disclosed in the annual financial statements.

### **Accounts payable**

20. The creditor's balance of R3.1 million in note 10 to the financial statements includes an amount of R485 400 being creditors with debit balances. Due to the lack of supporting documentation and explanations, we were unable to determine what these debit balances related to. If these debit balances represent genuine overpayments of creditors then they should have been recorded as debtors. Furthermore an amount of R178 875 in respect of stale cheques was included in the balance of R3.1 million and could not be supported with appropriate documentation.
21. Supporting documentation for a list of creditors to the value of R734 793 could not be provided for audit purposes.
22. Journals amounting to R3 million were debited from the creditors account and R5.9 million credited to creditors without supporting documentation.
23. As a result I was unable to obtain sufficient appropriate evidence to confirm the completeness, accuracy, obligations and valuation of the in creditors balance.

### **Accounts receivable**

24. The debtor balance of R10.1 million as disclosed in note 5 to the financial statements includes an amount of R226 298, being an amount owed by Mhlontlo municipality to itself. Debtors with credit balances amounting to R131 619 have reduced the balance of debtors. Due to the lack of supporting documentation and explanations, we were unable to determine what these credit balances relate to and whether these debtors should be disclosed as creditors.
25. The indigent portion of equitable share of R4.6 million was not deducted from individual debtors' accounts. As a result revenue and receivables are overstated by this amount.
26. Included in the debtors balance are amounts of R443 920 and R300 000 being payroll debtors and OR Tambo debtors respectively which could not be supported by appropriate documentation.
27. Evidence that the debtors selected for testing had settled their accounts subsequent to the year-end could not be obtained. As a result, I was unable to determine whether the provision for Doubtful Debts of R2.9 million disclosed in note 5 was sufficient.

28. There is an unreconciled difference of R695 152 between the debtors balance as per the financial statements and the debtors balance per the debtors' age analysis. No explanations or documentation were provided to support this difference.
29. As a result of the matters reported in paragraph 24 and 26 to 28, I was unable to obtain sufficient appropriate evidence to confirm the completeness, accuracy, existence and valuation of the in debtors balance as disclosed in the financial statements.

### **Revenue**

30. Grant revenue of R56.3 million included in total revenue of R66.7 million disclosed in the income statement is R1.3 million less than the amount reflected as due to the municipality in DORA for the 2008-09 financial year. This difference could not be adequately explained or supported by appropriate documentation.
31. Sundry income of R1.9 million is included in the total revenue of R66.7 million disclosed in the income statement. This amount could not be supported by documentation, explanations or other evidence. There were no alternative procedures that could be performed to confirm this amount.
32. The valuation roll used to support the assessment rates of R1.9 million included in the total revenue of R66.7 million disclosed in the income statement did not include all ratable properties within the municipality's boundary. As a result sufficient appropriate evidence relating to the completeness of the assessment rates revenue could not be obtained. There were no alternative procedures that could be performed to obtain this assurance.
33. A number of receipt books were missing during the current financial year and due to the break in sequence of receipts we were unable to confirm the completeness of revenue recorded.
34. As a result sufficient appropriate evidence relating to the completeness, accuracy, occurrence, compliance, cut-off and classification of revenue could not be obtained.

### **Disclosure**

35. The mandatory disclosures required by sections 123(1) and 125(1)(b) relating to allocations received by the national and provincial spheres of government, spending of allocations, compliance with conditions attached to grants and the contributions to and amounts due to organised local government.

### **Cash Flow Statement**

36. There was no supporting documentation for the prior year adjustment of R5.5 million on the cash flow statement. Furthermore, the prior year movement for an increase/decrease in trust and project funds is presented as a negative instead of a positive and the prior year movement for the net increase/decrease in cash and cash equivalents is presented as a positive instead of a negative.

### **Corresponding figures**

37. The audit report on the financial statements for the year ended 30 June 2008 contained a disclaimer of opinion on the financial statements taken as a whole. This was a result of significant uncertainties and a limitation on the scope of the audit. No adjustments have been effected to the financial statements to correct the matters raised in the prior year audit report. As a result, the effect of the prior year uncertainties and scope restriction on the accumulated surplus, property, plant and equipment, provisions, cash and cash equivalents, inventory, accounts receivables, investments, revenue, capital commitments and contingent liabilities could not be determined. The municipality has not addressed the issues raised in the previous audit report as required by section 131 (1) of the MFMA.

### **Disclaimer of opinion**

38. Because of the significance of the matters described in the Basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on the financial statements.

### **Other matters**

I draw attention to the following matters that are ancillary to my responsibilities in the audit of the financial statements:

### **Material inconsistencies in other information**

#### **Variances in appendix B and C**

39. A comparative amount of R3.4 million is not included in the current year's financial statements which resulted in a difference between the prior year financial statements and the prior year amounts as per the current year financial statements.
40. The budget amount for Contribution to fixed assets in the annual financial statements was R 25.4 million where the amount in appendix B was R22.7 million resulting in a difference of R 2.7 million.
41. The budget amount in the annual financial statements for Central Government and Other income was R55.9 million and R 9.7 million while the amount in appendix C was R45.7 million and R 19.9 million respectively resulting in a difference of R10.2 million for both budgets.

#### **Variances between Annual financial statements and appendix D**

42. Differences between the annual financial statements and detailed income statement (appendix D) exist. Revenue and expenditure has been disclosed as R66.7 million and R69.6 million where appendix D showed Revenue and expenditure as R68.5 million and R 66.2 million resulting in a difference of R1.8 million and R3.4 million respectively.

### **Unaudited supplementary schedules**

43. The supplementary information set out on pages xxx to xxx does not form part of the financial statements and is presented as additional information. I have not audited these schedules and do not express an opinion thereon

**Material non-compliance with applicable legislation**

44. The members of council have not disclosed their direct and indirect business interests as required by section 54 of the MSA read with paragraph 5(a) and (b) of schedule 1 code of conduct for councilors' of the MSA.

**Municipality property and rates act**

45. The municipality did not comply with the following sections of the municipal property rates act

- Section 32(1)(b) as valuation roll was not made within 4 years, the last valuation of properties was conducted in 2003.
- Section 77(a) & (b) as supplementary valuations were not performed and the valuation roll was also not updated.

**Municipal Finance Management Act**

46. The municipality did not comply with the following sections of the MFMA:
- Sections 65(2)(b) and (c) of the MFMA as payments to creditors were not made within 30 days of receiving the relevant invoice or statement.
  - Section 56 as the municipality did not prepare an adequate asset register with the required information.
  - Section 64 of the MFMA in that systems of internal control in the revenue were not maintained or implemented as cash was not banked on daily basis or within a reasonable time and reconciliations of cash received to records were not performed. Long outstanding debtors were also not followed up. A register of face value documents was not maintained or designed.
  - Section 95 of the MFMA, the systems of financial and risk management was not maintained or implemented as the management has not designed a fraud prevention plan.
  - Section 71 of the MFMA as monthly reports were not submitted to the mayor and relevant treasury. Furthermore the service delivery and budget implementation plan had not been approved by the mayor within 28 days after the approval of the budget.
  - Section 13(2) of the MFMA as appropriate and effective cash management and investment policies were not in place.
  - Section 62(1)(c)(i) as service level agreements was not entered to. Furthermore contracts to the value of R11 million were signed before the award date and management could not provide the audit with tender documents.
  - Section 62 of the MFMA as bank reconciliations, tax reconciliations and supplier reconciliations were not prepared monthly or on regular basis and there is no register for conditional grants.
  - Section 127 (2) & (3) of the MFMA in that the annual report for 2007/08 is still in draft format and has not been tabled by the council. The draft report does not include Auditor-General's report.

## Supply Chain Management

47. The municipality did not comply with the following sections of the SCM regulations issued in terms of the MFMA:

- Regulation 44 and 45 of the SCM has not been complied with for all contracts awarded by the municipality in the current financial year. No declarations of interests have been submitted to the municipality for all these contracts in the current financial year.
- Section 26(1) (a) has also not been complied with; the municipality does not have a tender specification policy and the municipality does not keep a bid register for all tenders that entered the bid.

## Governance framework

48. The governance principles that impact the auditor's opinion on the financial statements are related to the responsibilities and practices exercised by the accounting officer and executive management and are reflected in the internal control deficiencies and key governance responsibilities addressed below:

### Internal control deficiencies

49. Section 62(1)(c)(i) of the MFMA states that the accounting officer must ensure that the municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The table below depicts the root causes that gave rise to the deficiencies in the system of internal control, which led to the adverse opinion. The root causes are categorised according to the five components of an effective system of internal control. (The number listed per component can be followed with the legend below the table.) In some instances deficiencies exist in more than one internal control component.

Par. no.	Basis for an disclaimer opinion	CE	RA	CA	IC	M
4-6	Bank and cash			5		
7-9	Provisions	6	1			1
10-14	Expenditure			5		
15-16	Employee Costs			4	1	
17	Investments			4		
18	Irregular expenditure			3		
19	Unauthorised expenditure			5		
20-23	Accounts payables			5		
24-29	Accounts receivable	6				
30-34	Revenue			4		
35	Disclosure					
36	Cash Flow Statement	5				
37	Corresponding figures			4		

**Conclusion on the governance framework based on internal control deficiencies.**

- Management does not have an adequate process in place to ensure bank reconciliations were performed and reviewed regularly.
- Management does not have adequate records or proper controls in place to account for the movement in the provision accounts.
- Management did not review and ensure that expenses were recorded in the correct period. A system was not properly implemented which caused the lack of supporting documentation.
- Management was not committed to obtaining the necessary supporting documents for journals processed.
- Management does not have sufficient controls in place to ensure that irregular and unauthorized expenditure is identified and adequately disclose.
- Management did not implement a proper filing system to ensure that supporting documentation was available and they did not ensure that proper reconciliations were performed throughout the year.
- Management does not have an adequate system of internal control to ensure that the bad debts written off expense and the current year movement are correct.
- The municipality does not have an adequate system of internal control for the completeness of revenue and there is no process in place to ensure reconciliations are performed on a regular basis.
- Management does not have sufficient understanding of the disclosure requirements in terms of IMFO.
- Management does not have an adequate system of internal controls in place to ensure that all misstatements identified by the external auditors are corrected

<b>Legend</b>	
<b>CE = Control environment</b>	
The organisational structure does not address areas of responsibility and lines of reporting to support effective control over financial reporting.	1
Management and staff are not assigned appropriate levels of authority and responsibility to facilitate control over financial reporting.	2
Human resource policies do not facilitate effective recruitment and training, disciplining and supervision of personnel.	3
Integrity and ethical values have not been developed and are not understood to set the standard for financial reporting.	4
The accounting officer/accounting authority does not exercise oversight responsibility over financial reporting and internal control.	5
Management's philosophy and operating style do not promote effective control over financial reporting.	6
The entity does not have individuals competent in financial reporting and related matters.	7
<b>RA = Risk assessment</b>	
Management has not specified financial reporting objectives to enable the identification of risks to reliable financial reporting.	1
The entity does not identify risks to the achievement of financial reporting objectives.	2
The entity does not analyse the likelihood and impact of the risks identified.	3
The entity does not determine a risk strategy/action plan to manage identified risks.	4
The potential for material misstatement due to fraud is not considered.	5
<b>CA = Control activities</b>	
There is inadequate segregation of duties to prevent fraudulent data and asset	1



misappropriation.	
General information technology controls have not been designed to maintain the integrity of the information system and the security of the data.	2
Manual or automated controls are not designed to ensure that the transactions have occurred, are authorised, and are completely and accurately processed.	3
Actions are not taken to address risks to the achievement of financial reporting objectives.	4
Control activities are not selected and developed to mitigate risks over financial reporting.	5
Policies and procedures related to financial reporting are not established and communicated.	6
Realistic targets are not set for financial performance measures, which are in turn not linked to an effective reward system.	7
<b>IC = Information and communication</b>	
Pertinent information is not identified and captured in a form and time frame to support financial reporting.	1
Information required to implement internal control is not available to personnel to enable internal control responsibilities.	2
Communications do not enable and support the understanding and execution of internal control processes and responsibilities by personnel.	3
<b>M = Monitoring</b>	
Ongoing monitoring and supervision are not undertaken to enable an assessment of the effectiveness of internal control over financial reporting.	1
Neither reviews by internal audit or the audit committee nor self -assessments are evident.	2
Internal control deficiencies are not identified and communicated in a timely manner to allow for corrective action to be taken.	3

### Key governance responsibilities

50. The MFMA tasks the accounting officer with a number of responsibilities concerning financial and risk management and internal control. Fundamental to achieving this is the implementation of key governance responsibilities, which I have assessed as follows:

No.	Matter	Y	N
1.	No significant difficulties were experienced during the audit concerning delays or the availability of requested information.		✓
2.	The financial statements were not subject to any material amendments resulting from the audit.		✓
3.	The annual report was submitted for consideration prior to the tabling of the auditor's report.	✓	
4.	The annual financial statements were submitted for auditing as per the legislated deadlines section 126 of the MFMA.	✓	
5.	Key officials were available throughout the audit process.	✓	
6.	Audit committee		
	• The municipality had an audit committee in operation throughout the financial year.	✓	
	• The audit committee operates in accordance with approved, written terms of reference.	✓	
	• The audit committee substantially fulfilled its responsibilities for the year, as set out in section 166(2) of the MFMA.		✓
7.	Internal audit		

No.	Matter	Y	N
	<ul style="list-style-type: none"> <li>The municipality had an internal audit function in operation throughout the financial year.</li> </ul>	✓	
	<ul style="list-style-type: none"> <li>The internal audit function operates in terms of an approved internal audit plan.</li> </ul>		✓
	<ul style="list-style-type: none"> <li>The internal audit function substantially fulfilled its responsibilities for the year, as set out in section 165(2) of the MFMA.</li> </ul>		✓
8.	There are no significant deficiencies in the design and implementation of internal control in respect of financial and risk management.		✓
9.	There are no significant deficiencies in the design and implementation of internal control in respect of compliance with applicable laws and regulations.		✓
10.	The information systems were appropriate to facilitate the preparation of the financial statements.	✓	
11.	A risk assessment was conducted on a regular basis and a risk management strategy, which includes a fraud prevention plan, is documented and used as set out in section 62(c)(i) of the MFMA.		✓
12.	Delegations of responsibility are in place, as set out in section 79 of the MFMA.	✓	
13.	The prior year audit findings have been substantially addressed.		✓
14.	The information systems were appropriate to facilitate the preparation of a performance report that is accurate and complete.		✓
15.	Adequate control processes and procedures are designed and implemented to ensure the accuracy and completeness of reported performance information.		✓
16.	A strategic plan was prepared and approved for the financial year under review for purposes of monitoring the performance in relation to the budget and delivery by the King Sabata Dalindyebo Municipality against its mandate, predetermined objectives, outputs, indicators and targets section 68 of the MFMA.		✓
17.	There is a functioning performance management system and performance bonuses are only paid after proper assessment and approval by those charged with governance.		✓

Management's attention is specifically drawn to the following key governance responsibilities which, according to the above table, have not been effectively addressed:

51. Significant delays were experienced during the execution of our audit as a result of the Municipality not providing documentation and explanations required for audit purposes. A structured process was followed in an attempt to obtain the documentation and explanations. Management was regularly informed of the delays experienced. Most documentation and explanations required were only submitted after several attempts. This was due to inadequate systems, monitoring and supervision in place throughout the financial year
52. The financial statements require material amendments resulting from the audit. There were significant delays in the submission or non-submission of documentation supporting balances and information contained within the financial statements. There were various supporting documentation that did not substantiate the transactions and balances per the financial statement.

53. Although the Audit committee charter exists, it could not be relied on as a valid document as there is no proof that the charter was approved by the council.
54. The annual report has not been submitted for consideration prior to the audit report being signed as the Municipality is still in the process of preparing the annual report.
55. The Municipality has engaged the services of O.R Tambo District Municipality Internal Audit on shared basis for a period of 3 years. The Internal Audit operational plan did not include specifics on scope and extent of coverage. The internal Audit only performed work from February to June 2009 and its work could therefore not be relied on.
56. The information system was not adequate to facilitate the preparation of the financial statements. Management has not taken sufficient action to ensure that all legislative disclosure has been included in the financial statements. There is a lack of monitoring and supervision by management to ensure compliance with applicable laws and regulations
57. The municipality has not undertaken a risk assessment to assess any risk for fraud and has consequently not developed a fraud prevention plan. This is as a result of action plans and follow up on prior year issues not sufficiently addressed by management.
58. It was noted that there is insufficient delegations of responsibilities. Currently, management is short staffed as vital vacancies per the organogram have not been filled.
59. Management had an audit intervention plan in place to address prior year finding, however these plans were not implemented by management. This has resulted in prior year issues not being addressed by management.
60. The of source information and systems utilized to gather the information is not reliable.
61. There are no documented and approved policies and procedures in place for the reporting of performance information.

## **OTHER REPORTING RESPONSIBILITIES**

### **Reporting on performance information**

62. I was engaged to review the performance information

### **Responsibility of the accounting officer**

63. In terms of section 121(3)(c) of the MFMA, the annual report of a municipality must include the annual performance report of the municipality prepared by the municipality in terms of section 46 of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA).

### **Responsibility of the Auditor-General**

64. I conducted my engagement in accordance with section 13 of the Public Audit Act, 2004 (Act No. 25 of 2004) read with *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008* and section 45 of the MSA.

65. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate audit evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.

66. I believe that the evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

### **Audit findings (Performance information)**

#### **Non-compliance with regulatory requirements**

67. Section 6 of the MSA requires the municipality to establish, develop and monitor its performance management systems. The municipality did not collect, record and process information or monitor and report on development priorities and objectives for the performance management systems. As a result key performance indicators had not been set for each of the development priorities and objectives as set out in the integrated development plan

#### **Internal auditing of performance measurements**

68. The municipality did not develop and implement mechanisms, systems and processes for the auditing the results of performance measurement as part of its internal audit processes and thus contravened section 45 of the MSA

#### **Reported information not received on time**

69. An assessment could not be performed of the reliability of the reported information since the information was not received for audit purposes

### **APPRECIATION**

70. The assistance rendered by the staff of the municipality during the audit is sincerely appreciated.

*Auditor-General*  
Mthatha

17 May 2010



AUDITOR - GENERAL  
SOUTH AFRICA

*Auditing to build public confidence*